VZCZCXRO4179
PP RUEHRG
DE RUEHBR #0366/01 0521958
ZNR UUUUU ZZH
P 211958Z FEB 06
FM AMEMBASSY BRASILIA
TO RUEHC/SECSTATE WASHDC PRIORITY 4596
INFO RUEHRG/AMCONSUL RECIFE 4370
RUEHRI/AMCONSUL RIO DE JANEIRO 1575
RUEHSO/AMCONSUL SAO PAULO 6424
RUEHAC/AMEMBASSY ASUNCION 5247
RUEHBU/AMEMBASSY BUENOS AIRES 3813
RUEHMN/AMEMBASSY MONTEVIDEO 6073
RUEHSG/AMEMBASSY SANTIAGO 5359
RUEHCV/AMEMBASSY CARACAS 3142
RUEHME/AMEMBASSY MEXICO 1931
RUEHQT/AMEMBASSY QUITO 1741
RUEHPE/AMEMBASSY LIMA 2870
RUEHLP/AMEMBASSY LA PAZ 4393
RUEHBO/AMEMBASSY BOGOTA 3623
RHEHNSC/NSC WASHDC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

UNCLAS SECTION 01 OF 04 BRASILIA 000366

SIPDIS

SENSITIVE
SIPDIS

NSC FOR CRONIN
TREASURY FOR OASIA - DAS LEE, FPARODI
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
USDOC FOR 4332/ITA/MAC/WH/OLAC/JANDERSEN/ADRISCOLL/MWAR D
USDOC FOR 3134/ITA/USCS/OIO/WH/RD/DDEVITO/DANDERSON/EOL SON
STATE PASS USAID FOR LAC

E.O. 12958: N/A
TAGS: ECON EFIN EINV PGOV BR
SUBJECT: BRAZIL - THE EVER-RISING REAL AND OTHER MACROECONOMIC
TIDBITS

REF: A) 05 BRASILIA 3207
B) 05 BRASILIA 3306
C) BRASILIA 0327

¶1. (SBU) Summary: The torrent of dollars entering Brazil, fueled primarily by the trade surplus (over $44 billion in 2005) but also by FDI and portfolio investment flows, has created both opportunities and challenges for Brazilian macroeconomic policy management. GoB and private debtors are making use of the strong Real, which is trading at its most appreciated level since 2001, to pay down external or dollar-linked debt. As of February 9, the GoB had repurchased US$2.3 billion of its dollar-denominated external bonds. Investor perceptions of Brazil risk are at record lows despite the uncertainties associated with presidential elections in October. Taking advantage of this situation, the GoB has moved to improve its debt profile further by cutting taxes on foreign portfolio investment in domestically issued GoB bonds. Industry, on the other hand, is complaining loudly that the strong Real is cutting into export competitiveness and profits. They are behind a bill introduced in Congress which would liberalize the rules for foreign exchange transactions, eliminating a requirement that all revenues from exports be converted into Reais (ref C). More generally, the exchange rate and monetary policy already are shaping up to be an important point of the economic policy debate in this election year. End Summary.

The Real is Real Strong

¶2. (SBU) Strong dollar inflows continue to move the Brazilian Real to record (medium-term) levels. On February 20, the Real traded at around 2.11 to the dollar, its most appreciated level (in nominal terms) since 2001. Underpinning this performance are strong trade and current account balances, the latter reaching US$14.1 billion or 1.4% of GDP in 2005. Foreign Direct Investment (FDI) brought in another US$15.2 billion or 1.9% of 2005 GDP, reinforced by a further

US$6.6 billion in net portfolio investment inflows, the latter attracted in part by high real interest rates. (While in September 2005 the Central Bank began to lower nominal interest rates from their recent peak of 19.75%, market analysts expect that the benchmark SELIC rate will only reach 15% by year's end -- which would translate into a still high real interest rate of about 10%, given inflation expectations of about 4.5% for 2006.)

¶3. (SBU) The Central Bank continues to purchase dollars in both the spot and futures markets to build up reserves, which stood at US$57.27 billion on February 20 (even after the December prepayment of US$17 billion to the IMF). Separately, the Finance Ministry has pre-purchased US$9 billion to service external debt payments through June 2006. While a convenient device to brake the Real's upward momentum, these GoB dollar purchases were never intended to be full-scale interventions in the currency market and have slowed the Real's appreciation only marginally and temporarily. Moreover, the Central Bank expects further appreciation, according to a recent study -- the contents of which were shared with Econoffs by a Trade Ministry contact -- which posits that the Real/Dollar exchange rate will drop below 2 to 1 in the coming weeks/months. According to that document, the Central Bank did not plan to intervene in the market to prevent this. Separately, one ex-Finance Ministry official has predicted publicly that after breaching the R$2 barrier in March, the Real will drift towards the R$1.90 level -- the next psychological support point.

Debt Buy Back(s), Brazil Risk to Record Lows

¶4. (U) The GoB is taking advantage of the strong Real to improve its debt profile in several ways. Along with the December 2005 IMF

pre-payment, the GoB has announced a prepayment of its rescheduled Paris Club debt (ref B) and revealed that it had repurchased on secondary markets US$2.3 billion of its international bonds. A Finance Ministry press statement suggested that the GoB might repurchase as much as US$20 billion, including all of its Brady bond debt maturing over the 2006-2010 period. The GoB already has eliminated its exposure to dollar-linked domestic debt, removing a vulnerability that plagued Lula's macroeconomic team during the 2002 financial market crisis of confidence. These moves to improve the debt profile are part of the Finance Ministry's campaign to obtain an investment grade credit rating, a goal which would substantially reduce the GoB's financing costs.

¶5. (U) Reflecting the positive external scenario and debt profile improvements, investor perceptions of Brazil risk have fallen. Brazil's EMBI+ index, which measures these perceptions, hit an all-time low of 226 on February 10, 2006.

Tax Cuts for Foreign Portfolio Investment

¶6. (U) On February 15, 2006, the GoB issued Provisional Measure (MP) 281 exempting foreign investment in government securities (and in venture capital funds) from Brazilian income tax. (Note: MPs are a peculiar form of executive decree with immediate force of law, but which nevertheless must be ratified by Congress to become permanent.) Brazilian Treasury Secretary Joaquim Levy, the primary force behind the MP, said the principal goal of the measure is to increase the demand for domestically-issued Real-denominated government bonds by reducing transactions costs for foreigners. To date, the GoB has been able to obtain better terms (i.e. longer maturity, fixed interest rates) on its overseas issuances, including its Real-denominated bonds launched in the fourth quarter of 2005. The GoB hopes increased demand will help improve the profile of its domestic debt. As noted above, while it has eliminated its dollar-indexed domestic debt from its portfolio (much of which was replaced with debt linked to the SELIC), the GoB has made only incremental progress in moving away from SELIC-linked bonds, which still make up about half of its portfolio of domestically-issued securities.

¶7. (U) Meanwhile, the sensitivity of the GOB's stock of domestic

debt stock to variations in the benchmark SELIC overnight rate has complicated fiscal and monetary policy-making as last year's series of Central Bank interest rate hikes have had a big impact on the GoB's fiscal accounts. This increased reliance on SELIC-linked debt meant that 2005 interest expenditures were up significantly (by over 1% of GDP) from 2004 due to the Central Bank's cycle of monetary tightening in 2005. The GoB hopes an influx of foreign portfolio investment will help overcome the apparent reluctance of domestic investors in government bonds to move to inflation-indexed or fixed rate issues. By limiting the tax exemption to bonds which are not pledged in repurchase agreements, MP 281 aims to mitigate the risk of the tax rollback creating additional opportunities for speculators to bet against the Real during a financial crisis. Neither does the exemption apply to investment from countries without income tax (i.e. offshore tax havens) nor those where income is taxed at a rate of less than 20%.

¶8. (U) Whether the tax cut will indeed attract substantial inflows of new foreign portfolio investment, as the GoB hopes, is another story. The February 17 "Folha de Sao Paulo" reported that among Wall Street analysts the reaction to this move was mixed. One analysts was quoted as saying that all MP 281 does is to eliminate Brazilian taxes for investors from those countries, like the U.S., which do not have a double-taxation treaty with Brazil. Another pointed out that as Argentina and Mexico already have adopted similar measures, Brazil was merely keeping pace with these two

countries.

Industry Unhappy -- Dutch Disease?

¶9. (SBU) The same influx of foreign portfolio investment that the GoB hopes to attract with MP 281 worries industry groups, which already were unhappy with the appreciated Real and prevailing high interest rates. They have criticized the new tax exemption, noting that it increases the risk of currency appreciation. They argue that further strengthening of the Real, which many expect to occur, will continue to cut into export competitiveness and profit margins. Some local economists worry that the exchange rate is affecting investment decisions at the margins by reducing the expected profitability of new investments in tradable goods -- thus negatively impacting future economic growth. Raul Velloso, an economist with links to the opposition PSDB party, suggested to Econoff that the China-driven growth in commodity exports was creating a Dutch disease-like effect with respect to Brazilian industrial production, both of manufactured exports and import-competing products. Though manufactured exports nevertheless grew strongly in 2005, he argued they could not continue to do so, given the unfavorable exchange rate. One potential early sign of these effects is that, according to one study, many small and medium businesses stopped exporting in 2005 even as large companies (Motorola, Nokia, Volvo, Siemens, Alstom, Samsung) with greater management and financial capabilities boosted their exports strongly (all by over 100%).

¶10. (U) Industry is sponsoring its own legislative changes, working through congressional allies to introduce a bill to liberalize the foreign exchange regime (ref C). The bill would remove requirements that exporters convert all their foreign currency export proceeds into Reais, allowing them instead to hold domestic foreign-currency denominated bank accounts. This would, they hope, both reduce transaction costs and relieve some of the appreciation pressure on the Real.

¶11. (SBU) Comment: While the Real's vigor is in many senses a "rich man's problem," reflecting the underlying strengths of the Brazilian economy, it is shaping up to be a divisive political issue in this presidential election year, marking the boundary between Brazil's more economically interventionist-minded candidates and those who advocate a hands-off exchange rate policy approximating the status quo. Finance Minister Palocci has been notable for his absence from the current controversy over the strength of the Real, letting Levy be the public face of the ministry in making the case for the tax exemption to skeptical industry groups. After months of

scandal-dodging and continued rumors about his exit from the ministry to run for Congress and/or manage Lula's campaign, Palocci's reticence may simply indicate a desire to adopt a lower profile for a while.

¶12. (SBU) However, the issue that will receive the most focus among the press and the candidates is the high prevailing interest rates. Everyone is in favor of a faster reduction in interest rates -- except, of course, the GoB economic team (i.e. Central Bank Chief Meirelles and FinMin Palocci). The common refrain is that a speedier pace of rate cuts would help on the exchange rate side by slowing the appreciation of the real. Still, Meirelles and Palocci resist this for fear of reawakening the Brazilian economy's traditional nemesis: inflation. While decisions on the path forward will be difficult, in many ways Brazil is fortunate to face such a choice. Economic success has now provided the country with greater freedom to choose among available fiscal and monetary policy tools. The next government's macro-economic team may find, though, that greater freedom to choose necessarily brings along with it greater freedom to make mistakes.

LINEHAN